News & Views FROM THE WORLD

United States Embassy, Harare, Zimbabwe - March 2007

Volume 10

Free Copy

THIS ISSUE: Economic & Infrastructure Development

Boosting African Growth

"We can't have sustained poverty reduction and employment without growth."

Charles Soludo Governor of the Central Bank of Nigeria; Co-Chair, World Economic Forum on Africa

- ***While many countries in Africa are enjoying record growth, the challenge is to sustain the expansion and reduce poverty.***
- ***Growth in sub-Saharan Africa climbed to 5% in 2005, with inflation dropping to its lowest point in more than two decades.***
- ***Capital flows are now outpacing aid.***
- ***This offers Africa the opportunity to address persistent impediments to sustainability such as the skills shortage and the lack of infrastructure.***
- ***But 300 million Africans continue to live in dire poverty.***

Africa is experiencing record growth rates in many countries in a new era of peace, political stability and macro-economic reform. But the challenge is to ensure that this growth is sustainable and reduces poverty; it should not only be driven by high oil and commodity prices, or windfall investments from China. Increased revenues must be used to address problems in the business environment, build infrastructure, increase access to finance for entrepreneurs and improve health and education. These measures will help to unlock growth right down to the bottom of the pyramid to the rural poor.

Growth in sub-Saharan Africa reached an eight-year high of 5% in 2005, while average inflation fell to its lowest rate in 25 years. About 20 countries achieved growth of more than 5%. Coupled with surging commodity prices, improved governance and reduced conflict, Africa's fortunes seem to have changed for the better, with experts noting that the outlook is the best it has been for decades.

Growth has become Africa's new development strategy, which can be sustained through political stability and sound macroeconomic policies.

Yet, with an estimated 300 million Africans still living in dire poverty, Africa is by no means out of the woods yet and many questions remain. What is driving this growth and who is benefiting? Is it sustainable? Is it creating jobs? Is it reducing poverty? What is holding back even greater growth?

South African President Thabo Mbeki said, "Without growth we simply cannot deal sustainably with the issues of poverty and underdevelopment."

While the Commission for Africa has called for massive increases in aid, some believe Africa is receiving too much, propping up otherwise unviable states and reducing governments' willingness to deal with problems. There is little evidence to suggest that aid is linked to growth. "The current foreign aid system works very well for everyone except poor people," according to William Easterly, Professor, Economics Department, New York University, USA. But President Jakaya M. Kikwete of Tanzania, counters that, in reality, many countries simply do not have the resources to survive without aid, even when they have good policies.

Nonetheless, capital flows to Africa have increased to the point where they now outpace the US$ 25 billion in aid. Remittances flowing into Africa dramatically increase such flows by more than US$ 10 billion and are seen as an important catalyst for increased economic activity.

However, many challenges remain. There are predictions that Africa will be the only region that is unable to meet the Millennium Development Goals (MDGs) despite claims that the goals are overambitious for Africa and were developed without input from Africans because the growth Africa is experiencing is not necessarily reducing poverty.

Skills shortages are a major constraint to sustainable growth. Greater investment in quality education and skills training is required to address the problem.

Addressing the business and investment climate is crucial for increased growth. Areas needing to be addressed include removing excessive bureaucracy and regulation, improving customs and tax administration, providing viable micro finance institutions, addressing crime and corruption, deepening financial markets and addressing property rights and contract enforcement, among others. Countries can sustain growth in their revenue base only by increasing private sector activity and bringing more businesses into the tax net.

The Investment Climate Facility, launched at the World Economic Forum on Africa in

Continued on Page 3

Growth and Poverty: A simultaneous challenge

Traditionally, economists and policymakers have distinguished between two main approaches to poverty reduction economic growth and income redistribution. Countries that have pursued growth led poverty reduction, such as China, Vietnam, India, have been more successful in lowering absolute poverty than countries that have focused primarily on redistribution. Redistribution was popular throughout the nineties in several countries in North Africa. Although they achieved more equitable distribution of income, this came at the price of a stagnant GDP and failure to lower poverty rates. In contrast, during the same period, China pursued growth-oriented economic policies and absolute poverty in China fell from over 80% in 1980 to about 5% now. However, income distribution there became more unequal. Comparing these results, one might conclude that economic growth is the key to poverty reduction, and income inequality is a price that must be paid. However, if inequality is high to begin with, as it is in most of Southern Africa, all benefits of growth may accrue only to those at the top, making them ever richer, while barely touching the poor. South Africa, for example, has recorded relatively strong economic growth rates since 1994, but disappointing poverty reduction rates, precisely because the "trickle down effect" has not occurred. Policymakers now look to pro-poor growth both to drive the economic engine and improve the lives of the poor. Pro-poor growth is not the same as income redistribution. Rather, it means that the income of people at the lowest end of the curve rises faster than the increase in overall GDP and the gap between the richest and poorest closes. While there isn't a "one size fits all" set of policies that promote pro-poor growth, international experience shows that country-specific pro-poor growth strategies can simultaneously both reduce poverty and improve productivity in the economy as a whole.

Ghana: Accelerating Growth to Halve Poverty

Country Indicators	1983	2001	2005*
GDP per capita (US$)	181	270	400
CPI (% change)	123	21.3	14.8
External debt (% of GDP)	—	117	48
Poverty headcount index (%) 5	2 (1992)	42 (1997)	35 (2003)
Gross primary school enrollment rate (%)	—	81 (2002)	92
Under-five child mortality rate (per 1,000)	143 (1985)	100 (2000)	95 (2003)
Population (millions)	12.5	20.4	21.0

Sources: Ghana Statistical Service (GSS), International Monetary Fund and World Bank.

** Estimate.*

Ghana has brought down poverty levels from 52 percent in 1992 to 35 percent in 2003. It is likely to surpass the Millennium Development Goal of halving poverty by 2015. Economic growth has averaged 4.5 percent from 1983 through 2000, but accelerated to 5.8 percent in 2004 and 6 percent in 2005 in response to the government's program of reforms. Ghanaians' access to electricity is the highest in Sub-Saharan Africa outside South Africa.—IDA

International Development Association (IDA)

Vietnam: Laying the Foundation for Steady Growth

Country Indicators	1993	2005
GNI per capita (Atlas method, US$)	170	620
Inflation (CPI, annual rate, %)	8.4	8.4
External debt (% of GNI)	91	33
Poverty incidence (% of population with consumption below basic needs level)	58	20 (2004)
Net primary school enrollment rate (%)	77 (1990)	94(2004)
Under-fi ve child mortality rate (per 1,000)	53 (1990)	23 (2004)
Maternal mortality rate (per 100,000 live births)	200	80
Population (millions)	70.3	83
Population growth rate (% per year)	2	1

Source: Vietnam, General Statistics Office; World Bank, Development Data Group.

Vietnam is one of the best-performing developing economies in the world. It is going through a far-reaching transformation from an inward-looking planned economy to one that is globalized and market-based. It has the potential to be one of the great success stories in development. —IDA

International Development Association (IDA)

In this issue

AN INTRODUCTION

Infrastructure for Economic Development in Africa

By W. T. Oshikoya and M. Nureldin Hussain

Physical Infrastructure, comprising telecommunications, power, transport, water supply, and information technology, is often viewed as the "wheels" of economic activity since it provides the environment for productive activities to take place and facilitates the generation of economic growth. In the absence of adequate power, water, transport and communication facilities, for example, production processes or locational advantages may not be optimised. By efficiently moving goods and services to where they can be used most effectively, transport adds value and spurs growth. The provision of power permits the use of modern technologies and processes. Efficient infrastructure development is necessary if the national economy is to be integrated and the benefits of economic growth are to be spread throughout a country. The provision of infrastructure encourages investment in less developed areas, allows wider movement of goods and people, facilitates information

flows and helps commercialise and diversify the economy. The development of regionally focused infrastructure projects facilitates the process of regional integration and assists in increasing the project size. The larger scale economies will attract private investment and enable the development of transport networks, telecommunications, power and markets that sustain expanding private sector activities and regional markets. Infrastructure services are central to poverty reduction. The activities of households and the lack of access to infrastructure are real welfare issues, particularly in rural areas where poverty is most predominant. The existence of an adequate rural infrastructure is a sine qua non for successful rural transformation and agricultural development.

Inadequate infrastructure in Africa is a major obstacle to the region's economic growth, and adversely affects the living standards of its people. The inadequate state of infrastructure has adverse impacts on health, education and the capacity of local producers as well as their ability to compete in international markets. The purpose of this paper is to take stock of them state of infrastructure in Africa and assess the significance of infrastructure in the development of the continent. The paper also explores the strategies and policies required for improving infrastructure services in the pursuit of Africa's overarching objectives of regional integration, private-sector- led growth and poverty reduction.

For the full text of the publication "Infrastructure for economic Development in Africa" contact :
OECD Publications
2, Rue André Pascal,
75775 Paris Cedex 16
www.oecd.org
http://unpan1.un.org/intradoc/groups/public/documents/IDEP/UNPAN006401.pdf

SPECIAL FOCUS

AMERICAN BUSINESS ASSOCIATION OF ZIMBABWE
ABAZ

We highlight presentations from guest speakers at The American Business Association of Zimbabwe Conference held on the 5th of October 2006. Entitled "Just Business" participants from the region and around the world, made an effort to identify the causes and propose solutions to the economic crisis in Zimbabwe.

An assessment of Zimbabwe's physical infrastructure

By Robert Geddes

Zimbabwe is fortunate to possess well developed basic infrastructure in key sectors of the economy such as water, road and railway. In some sectors infrastructure is not being used to its full capacity. In other sectors the infrastructure is inadequate and major investment is required to meet the growing demand. In all sectors (except mobile telephones) service delivery is declining as a result of inadequate investment and lack of maintenance. This is due to inadequate tariffs and user charges, compounded by high interest rates, hyper-inflation and shortages of foreign exchange. Infrastructure sectors are also experiencing severe management constraints due to the departure of experienced technicians and managers to other countries.

Good infrastructure is essential to support economic and social development. A study conducted by the World Bank (Zimbabwe Infrastructure Assessment Note for Roads, Railways, and Water Sectors (2006)) estimates that the road sector requires an investment of about US$1.7 billion, the energy sector about US$3.4 billion, and the water sector about US$10 billion in order to restore normal levels of service. These amounts will continue to increase over time, particularly since Government allocations for maintenance of infrastructure are generally inadequate.

The surplus capacity that is found in some sectors is due to decreasing demand linked to economic decline. For instance the spare capacity now found at the country's airports is closely linked to reduced tourist arrivals. Industrial buildings, many of which were developed for the processing and storage of agricultural products, are now underutilized due to declining farm output. Dams built for irrigating farm land are underutilized for the same reason. Tourist infrastructure is also underutilized, with all hotels in the country recording low occupancy rates. According to the Zimbabwe Tourism Authority the bed occupancy rate declined from 1,169,000 (42 percent) in 1999 to 766,986 (28 percent) in 2005.

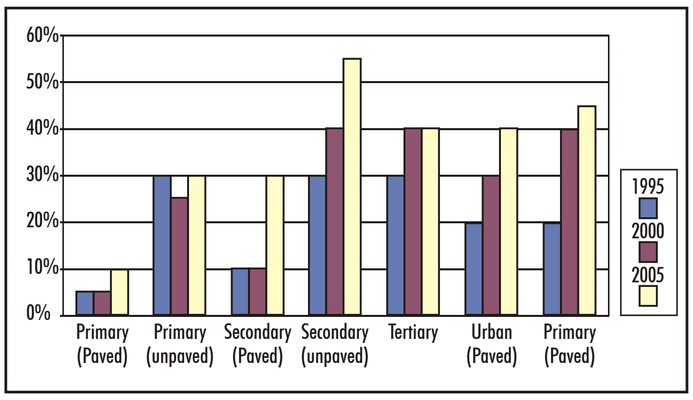
The condition of the Zimbabwe road network—one of the largest by regional standards—is deteriorating due to inadequate maintenance, leading to increased vehicle operating costs. The rail network—which is also extensive, connecting all of the main centers and providing links to neighboring countries—has its operations constrained by deteriorating track condition, low locomotive availability and high indebtedness of the National Railways of Zimbabwe (NRZ).The underutilization of some infrastructure affects other infrastructure. For instance there is an increase in heavy traffic on the Hwange to Bulawayo road transporting coal from Hwange Colliery. The railway system is well suited for such loads, but transporters of coal prefer to use road transport because of inefficiencies of the NRZ. The result is an accelerated rate of deterioration of the road.

According to ZESA about US$3.8 billion is required to increase power generation capacity to produce the 2,000 megawatts that the country needs.

Some sectors have inadequate basic infrastructural capacity. Most of these are closely linked to the provision of social services to the population. They include water supplies, sanitation, low cost housing, energy and telecommunications. Local authorities in the main cities, particularly Harare, are failing to provide sufficient water to consumers. Water is not always being purified to acceptable standards for drinking, and a significant proportion of treated water is lost through leaks in the pipe distribution network. Sewerage treatment plants are overloaded, with partially treated effluent routinely discharged into public streams.

The delivery of low cost housing is constrained by the shortage of serviced stands and high borrowing rates. The demand for housing continues to increase because of rural to urban migration. Local media reports state that in early 2005 it was estimated that the waiting list for housing in Harare had increased to about 100,000.

The energy sector is now dependent on imported power from the region, with only the hydroelectric generating facility at Kariba operating at close to its installed capacity. The Hwange Thermal Power Station is producing about one-third of its full capacity and the other three thermal power stations are reportedly not generating power due to lack of coal and foreign currency to maintain the equipment. As a result the Zimbabwe Electricity Supply Authority (ZESA) is failing to meet demand from its own power stations, yet it is unable to import sufficient power to meet the deficit. This has resulted in power cuts and load-shedding, which have adversely affected both domestic and



Portion of Zimbabwe Road Network in poor condition

industrial consumers. ZESA is also operating at a significant financial loss. Income in the first six months of 2006 was Z$5.7 billion against expenditure of Z$17.6 billion. The financial losses are linked to uneconomic tariffs charged by the utility. As a result, some consumers have resorted to generating their own electricity with on-site generators to ensure a reliable supply. According to ZESA about US$3.8 billion is required to increase power generation capacity to produce the 2,000 megawatts that the country needs.

The telecommunications sector is operated on more commercial lines than the other infrastructure sectors and therefore tends to provide a higher level of service. The number of mobile subscribers in March 2006 was reported to be close to 800,000 and increasing at a rate of about 50% per annum. The number of fixed telephone lines in service is about 330,000. The fixed line network is operated by parastatal TelOne.

Recent investments by three mobile telephone companies have resulted in improved availability of lines, whereas upgrading of equipment on the fixed line network has been delayed due to funding constraints. Improvements to the telecommunications system have tended to benefit urban dwellers, with limited geographical coverage of mobile operators, and rural fixed line networks still relying on a high proportion of analogue exchanges. The Internet industry in Zimbabwe has expanded significantly since 2000, with the market dominated by private companies. There are estimated to be about 900,000 Internet users in Zimbabwe and there are five major Internet Service Providers (ISPs). An increasing number of

Zimbabweans are using information technology as a channel of communication, resulting in a huge growth area for ISPs. However, Internet users that rely on dial-up connections continue to experience slow browsing speeds due to limitations of the fixed line telephone network; and foreign exchange shortages have restricted the supply of Internet bandwidth through TelOne.

The scale of investment required in infrastructure sectors to reverse years of decline and meet the demands of a growing population is now significant. The restoration of service levels in the key infrastructure sectors in Zimbabwe depends on a number of key factors.

MAJOR OBSERVATIONS

- Sectors with excess capacity offer opportunities for rapid restoration of service levels
- Major investments now required to restore serviceability in other sectors
- Inadequate funding for maintenance
- Brain drain
- Private sector operated infrastructure is operating more efficiently than government operated infrastructure.

First, there is need for stronger government policy statements in support of better coordination and increased commercialization. Increased commercialization of infrastructure services would encourage private sector investment and greater involvement of private sector skills.

Secondly, substantial increases in finance available for the development, rehabilitation and maintenance of infrastructure are required. Improved financing would enable infrastructure sectors, both public and private, to improve employment conditions, thereby restoring management capacity through reversal of the brain drain. It is unlikely that the required levels of investment can be achieved by the Zimbabwe government from internal resources, particularly under current economic conditions. The requirements of the infrastructure sectors can only be met though foreign investment or the support of international donors

Robert Geddes is a Civil Engineer based in Harare. This article is an abridged version of his presentation at the "Just Business" forum hosted by the American Business Association of Zimbabwe (ABAZ) in Harare earlier this year. The full paper can be obtained from ABAZ, e-mail abaz@mweb.co.zw

Continued from Page 1

Boosting African Growth

2006, aims to tackle many of the problems that keep investors at bay and that compromise the private sector's ability to stimulate economic activity and revenue generation. Removing the obstacles to doing business would also have the effect of reducing investor risk.

The issue of competitiveness of African products, as well as increasing the levels of intra-African trade need to be tackled with the same vigour given to the problems in the international trade agenda. Companies must be competitive in their own regions before they can effectively compete in the global arena. Business should become more engaged in trade issues, since it is companies that trade, not governments.

Africans believe the continent needs to develop a strategy to deal with the overwhelming wave of trade and investment from China, notably in extractive industries. The continent should not be left worse off once the boom ends; deals must be made more sustainable through, for example, downstream linkages and local partnerships.

Infrastructure is crucial to development and Africa needs to develop stronger public-private partnerships to address the backlogs, as well as reducing the risk to investors in large projects. Rural infrastructure has been identified as a priority because of the potential to unlock growth in poorer and marginalized areas. Technology should be used to promote health, education and trade in rural areas.

Africa's current growth rates are being driven in part by record oil and commodity prices. African countries need to find ways to allow the positive economic growth they are experiencing to trickle down to the people who need to benefit the most the poor.

This is not only the responsibility of government, but must also involve business and civil society. Former President of Mozambique Joaquim Chissano summarized, "In the past it was just state, state, state. Now we say we have the state, the private sector and civil society it is a partnership."

Courtesy of The World Economic Forum, www.weforum.org

Building an efficient road network

Public-private partnerships hold the key to regional infrastructure

By Gumisai Mutume

As far back as the 1960s, architects of African integration agreed that building infrastructure was vital to lubricate the wheels of intra-African trade and distribute its benefits regionally. The continent's leaders embarked on ambitious projects such as the trans-African highways -- segments of which would eventually stretch from Cairo to Dakar, Tripoli to Windhoek and Lagos to Mombasa. These would provide access to the sea to 15 landlocked countries and improve regional links.

There are too few roads in Africa, and they are deteriorating.

"Unfortunately, like the economic integration process, regional infrastructure cooperation and integration has not been an outstanding success," notes eminent Nigerian scholar and proponent of integration, Prof. Adebayo Adedeji. At the turn of the millennium a major drawback to trade among African countries remains the dire lack of infrastructure.

Africa lags behind the rest of the world in all aspects of infrastructure development -- quantity, quality, cost and access. In 1997, Africa (excluding South Africa) had 171,000 kilometres of paved roads -- about 18 per cent less than Poland, a country roughly the size of Zimbabwe. As efforts to complete the trans-African highways continue, the quality of existing roads is deteriorating. In 1992 about 17 per cent of sub-Saharan Africa's primary roads were paved, but by 1998 the figure had fallen to 12 per cent, reports the World Bank. Today, more than 80 per cent of unpaved roads are only in fair condition and 85 per cent of rural feeder roads are in poor condition and cannot be used during the wet season. In Ethiopia, 70 per cent of the population has no access to all-weather roads.

In many countries, roads are concentrated in urban areas or around coastal ports — trade routes established during colonial times for the overseas shipment of commodities. Far fewer roads link neighboring countries in regional networks.

Costly transport woes

Poor infrastructure makes the costs of transporting goods in Africa among the highest in the world, notes ECA Executive Secretary K.Y. Amoako. African goods are therefore less competitive with those from other regions.

A poor transport system "acts as a non-tariff trade barrier," concurs Prof. Kenneth Button, a public policy expert at George Mason University in the US, who has conducted transportation studies for the European Union.

World Bank studies show that a 10 per cent drop in transport costs could result in a 25 per cent increase in total African trade. The Bank also concludes that only about 25 per cent of the decline in Africa's share of world exports can be attributed to poor prices, while the rest is due to non-price factors such as poor infrastructure and information services.

Bad roads, aged vehicles and lax regulations also cost lives. The continent's road fatality share is three times as large as its share of motor vehicles. In a sample of African countries, 339 deaths per 10,000 vehicles were reported in 1996. In comparison, the average death rate in the world's 10 most highly motorized countries was 2.3 per 10,000 motor vehicles that year, according to the Global Road Safety Partnership, a worldwide road safety organization.

Financing gap

As moves towards regional integration gain momentum, ways of overcoming Africa's transport problems are being sought. Building infrastructure involves significant initial outlays of capital and continuous expenditure on maintenance and management. "Most African governments are in no position to provide this on any significant scale," notes Prof. Button. Therefore, international agencies have traditionally been major contributors.

Crude estimates show that $18-25 billion per year is required to provide adequate infrastructure in Africa. The continent currently only invests about $5 billion annually.

Commercialization of infrastructure delivery may be the answer, suggests Alhaji Bamanga Tukur, former director of the Nigerian Port Authority. He says the private sector in Africa has tremendous capacity to develop infrastructure if there is a transparent and supportive policy environment. Mr. Tukur gives the example of MTN of South Africa and Econet of Zimbabwe, two companies that recently won tenders to operate a mobile telephone system in Nigeria. Of note, he says, was that 50 per cent of the total capital, $500 million, was mobilized within Nigeria.

Partnerships

The state, however, cannot be allowed to abdicate its role as the dominant provider of infrastructure, especially in rural areas where development remains dependent on public or donor funding, says Social Affairs Minister Dolor Ernesta, of the Seychelles.

Mr. Ernesta argues that private investors will rush into sectors with quick returns, such as mobile telephones, but "it does not make economic sense [for them] to become engaged in many of the infrastructure developments that we need to implement in Africa."

These include building roads at great cost and little or no returns in remote rural areas. In Ethiopia, for example, bringing 90 per cent of the population within 20 kilometres of an all-weather road would cost an estimated $4 bn -- equivalent to 75 per cent of annual gross domestic product.

In any case, the record of the private sector in infrastructure investment in Africa has been poor. Between 1982 and 1994 private companies financed projects worth $340 mn, notes the ECA. In comparison, Latin American private companies invested $10.5 bn in infrastructure during the same period.

Some countries are introducing innovative ways of bringing the state and the private sector into joint ventures to raise capital. In South Africa, the BOT (build, operate, transfer) and FROM (finance, rehabilitate, operate and maintain) systems rely on private finance to design, construct and maintain roads. Once the roads are built, private operators charge tolls to recover costs and realize a reasonable return on investments before transferring ownership to the state.

In other parts of Africa, road funds overseen by public-private boards have been established. They are run independently, include road users on their boards and are subject to external audits. Money is raised from vehicle licences and user fees and jobs are contracted out to private developers.

While adequate infrastructure is essential for helping to promote trade among African countries, increased regional trade, in turn, could stimulate the growth of regional transport networks. The persistence of the trade patterns inherited at independence has been a factor holding back the development of integrated infrastructure in Africa, says Prof. Adedeji. "As long as Africa's trade pattern does not change in form, content and direction, the impetus to alter the continent's infrastructure systems will remain timid."

Africa Recovery, Vol.16 #2-3

When is it Hyperinflation?

by Michael K. Salemi

Inflation is a sustained increase in the aggregate price level. Hyperinflation is very high inflation. Although the threshold is arbitrary, economists generally reserve the term hyperinflation to describe episodes where the monthly inflation rate is greater than 50 percent. At a monthly rate of 50 percent, an item that cost $1 on January 1 would cost $130 on January 1 of the following year.

Hyperinflations are largely a twentieth-century phenomenon. The most widely studied hyperinflation occurred in Germany after World War I. The ratio of the German price index in November 1923 to the price index in August 1922 just fifteen months earlier was 1.02 × 1010. This huge number amounts to a monthly inflation rate of 322 percent. On average, prices quadrupled each month during the sixteen months of hyperinflation.

While the German hyperinflation is better known, a much larger hyperinflation occurred in Hungary after World War II. Between August 1945 and July 1946 the general level of prices rose at the astounding rate of over 19,000 percent per month, or 19 percent per day.

Even these very large numbers understate the rates of inflation experienced during the worst days of the hyperinflations. In October 1923, German prices rose at the rate of 41 percent per day. And in July 1946, Hungarian prices more than tripled each day.

What causes hyperinflations? No one-time shock, no matter how severe, can explain sustained (i.e., continuously rapid) price growth. The world wars themselves did not cause the hyperinflations in Germany and Hungary. The destruction of resources during the wars can explain why prices in Germany and Hungary would be higher after them than before. But the wars themselves cannot explain why prices would continuously rise at rapid rates during the hyperinflation periods.

Hyperinflations are caused by extremely rapid growth in the supply of "paper" money. They occur when the monetary and fiscal authorities of a nation regularly issue large quantities of money to pay for a large stream of government expenditures. In effect, inflation is a form of taxation where the government gains at the expense of those who hold money whose value is declining. Hyperinflations are, therefore, very large taxation schemes.

During the German hyperinflation the number of German marks in circulation increased by a factor of 7.32 × 109. In Hungary, the comparable increase in the money supply was 1.19 × 1025. These numbers are smaller than those given earlier for the growth in prices. In hyperinflations prices typically grow more rapidly than the money stock because people attempt to lower the amount of purchasing power that they keep in the form of money. They attempt to avoid the inflation tax by holding more of their wealth in the form of physical commodities. As they buy these commodities, prices rise higher and inflation accelerates.

Hyperinflations tend to be self-perpetuating. Suppose a government is committed to financing its expenditures by issuing money and begins by raising the money stock by 10 percent per month. Soon the rate of inflation will increase, say, to 10 percent per month. The government will observe that it can no longer buy as much with the money it is issuing and is likely to respond by raising money growth even further. The hyperinflation cycle has begun. During the hyperinflation there will be a continuing tug-of-war between the public and the government. The public is trying to spend the money it receives quickly in order to avoid the inflation tax; the government responds to higher inflation with even higher rates of money issue.

Inflation 1923-24: A German woman feeding a stove with currency notes, which burn longer than the amount of firewood they can buy.

How do hyperinflations end? The standard answer is that governments have to make a credible commitment to halting the rapid growth in the stock of money. Proponents of this view consider the end of the German hyperinflation to be a case in point. In late 1923, Germany undertook a monetary reform creating a new unit of currency called the rentenmark. The German government promised that the new currency could be converted on demand into a bond having a certain value in gold. Proponents of the standard answer argue that the guarantee of convertibility is properly viewed as a promise to cease the rapid issue of money.

An alternative view held by some economists is that not just monetary reform, but also fiscal reform, is needed to end a hyperinflation. According to this view a successful reform entails two believable commitments on the part of government. The first is a commitment to halt the rapid growth of paper money. The second is a commitment to bring the government's budget into balance. This second commitment is necessary for a successful reform because it removes, or at least lessens, the incentive for the government to resort to inflationary taxation. Thomas Sargent, a proponent of this second view, argues that the German reform of 1923 was successful because it created an independent central bank that could refuse to monetize the government deficit and because it included provisions for higher taxes and lower government expenditures.

What effects do hyperinflations have? One effect with serious consequences is the reallocation of wealth. Hyperinflations transfer wealth from the general public, which

Continued on Page 5

Taming inflation: Learning from Brazil's experience

By Dr. Caio Megale

Zimbabwe's current economic environment bears stark resemblance to the situation in Brazil 20 years ago. At the time, Brazil experienced high levels of inflation significantly above double-digits per year for practically the entire second half of the 20th century.

In the 1960s and 70s, inflation in Brazil was controlled at relatively palatable levels of around 20% per year, and economic growth was significant, financed by a high degree of indebtedness. Brazilians generally accepted this gradual rise in prices because overall economic growth was relatively good. In fact, inflation was seen as the undesired consequence of economic development. To protect the salaries of workers, the government introduced indexation, whereby wage contracts were adjusted to match inflation.

However, after the 1970s, economic growth stalled and inflation skyrocketed from around 300 percent to 2,000 percent. At this point inflation became a tremendous problem and economic policy makers realized they had to tackle the problem.

There are a number of costs of high inflation. High inflation decreases the predictability of economic variables. With no predictability you cannot invest and the potential growth of the country collapses. Inflation is also a powerful income concentration instrument. Real wages are eroded and poor people do not have access to financial protection. In the end, their economic situation worsens under inflation..

Dr. Caio Megale

Brazil's experience in combating inflation provides us with important lessons. First, we have to bear in mind that any disinflation plan involves important costs, mainly in terms of social well-being. Thus, the perception that inflation is a major obstacle to the country's development must be accepted by most of society, and all efforts must be made to overcome this obstacle.

Another important lesson is that one should not succumb to the temptation to carry out social justice during the implementation of a stabilization plan. The stabilization plan must be neutral from an income distribution standpoint. Otherwise, stability will bring a distortion of relative prices, and pressure to realign prices will tend to bring the inflationary process back.

The common reaction of authorities is to stabilize prices to protect the population from spiraling costs. In Brazil, each new attempt to stabilize prices was followed by periods (increasingly shorter) of some stability, before inflation returned with even greater vengeance. Lasting stabilization was only achieved with the implementation of the Real Plan in 1994. A combination of bold measures, well-grounded on economic theory, with the lessons learned from a series of ill-fated experiments, enabled Brazil to reduce inflation, which, at that moment, exceeded 1000% p.a., to single-digit territory, where it remains to this day, 12 years later.

Before the 1994 Real Plan, the Brazilian government introduced monetary reform that established a new currency in February 1986. This reform was accompanied by a series of measures such as freezing of prices and salary increments. Between March and June 1986, inflation came down strongly from over 400% p.a. to between 10-15% p.a. However, two crucial errors were made: for all practical purposes, salaries were not frozen, and the clear signs of excess aggregate demand in the following months were not combated. Bonuses were granted to the lower classes via a 16% hike in the minimum wage, and the dates of the collective labor agreements were reestablished. In addition, salaries were corrected based on 60% of the accumulated variation of the cost of living in the 12 previous months, and a trigger was implemented to automatically correct salaries whenever accumulated inflation totaled 20%.

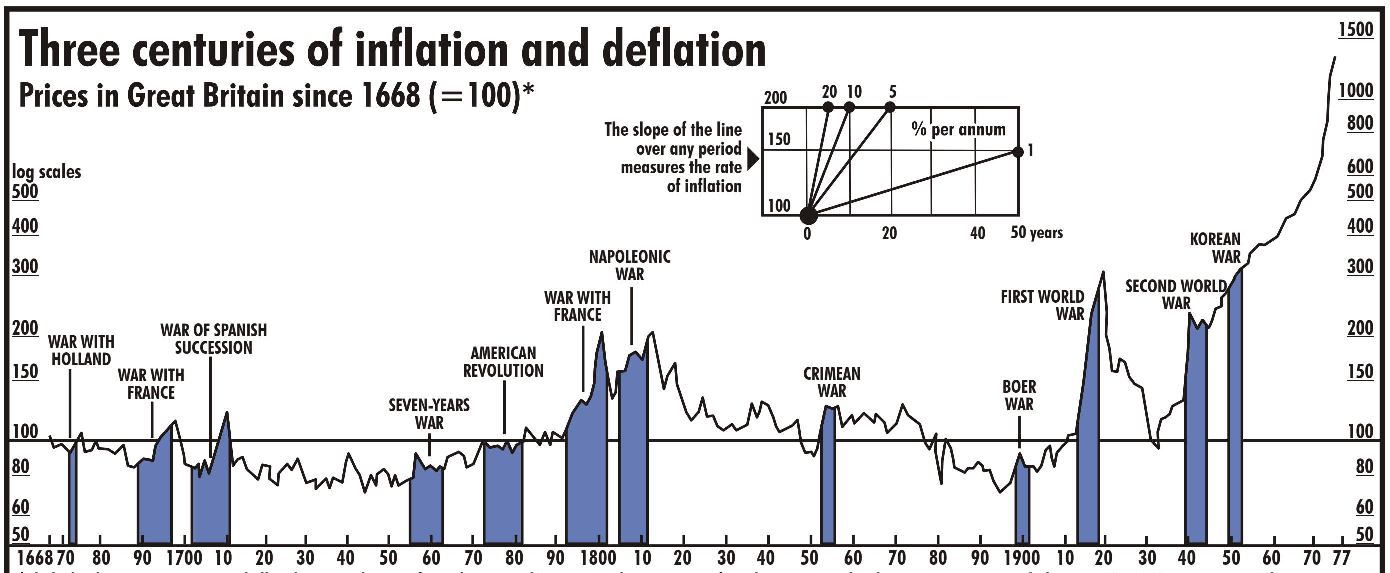
This currency reform failed, prompting government to introduce other packages in the ensuing years They all had similar diagnosis and consequences.

One such plan was launched in March 1990 by the economic team of President Fernando Collor, the first president elected by popular vote in Brazil in almost 30 years. Although it failed, the Collor government achieved important steps in the structural reform of the Brazilian economy that were crucial to the success of the Real Plan in later years: it launched the process to privatize state-owned companies and promoted a broad opening of the economy to foreign trade.

Learning from past failures, the Real Plan embarked on a new anti-inflation strategy. While many past plans started with price and wage freezes that were announced by surprise, the Real Plan did not make use of any direct control of prices or surprise announcements. In fact, the main innovative characteristic of the Real Plan was its transparency following the catchphrase of the economic team at the time of the launch of the plan: "announce only what will be done and do only what was announced". Also key to the plan's success was the role of the Minister of Finance in protecting the economic team from political interference, as political pressure had been the main cause of previous failures.

The first phase of the Real Plan consisted of controlling government spending. The Brazilian legislature approved a constitutional amendment increasing the power of the Treasury to transfer funds to fulfill the budget. With the fiscal side heading towards equilibrium, the next step was to move towards the full indexation of the economy.

The first step was to create a unit of account that would serve



Three centuries of inflation and deflation

Prices in Great Britain since 1668 (=100)*

* linked index. Main sources: Mitchell and Deane, Abstract of British Historical Statistics and Department of Employment, British Labour Statistics Historical Abstract 1886-1953. Basic series: Schumpeter - Gilboy price index 1661-1697 (1697=100) and 1697-1823 (1701=100); Rousseaux price indices 1600-1923 (1869-1885=100); Sauerbuck-Statist price indices 1864-1938 (1887-1877=100); DE index of internal purchasing power of the pound 1914-1977 (1963=100)

Continued from Page 4

holds money, to the government, which issues money. Hyperinflations also cause borrowers to gain at the expense of lenders when loan contracts are signed prior to the worst inflation. Businesses that hold stores of raw materials and commodities gain at the expense of the general public. In Germany, renters gained at the expense of property owners because rent ceilings did not keep pace with the general level of prices. Costantino Bresciani-Turroni has argued that the hyperinflation destroyed the wealth of the stable classes in Germany and made it easier for the National Socialists (Nazis) to gain power.

Hyperinflation reduces an economy's efficiency by driving agents away from monetary transactions and toward barter. In a normal economy great efficiency is gained by using money in exchange. During hyperinflations people prefer to be paid in commodities in order to avoid the inflation tax. If they are paid in money, they spend that money as quickly as possible. In Germany workers were paid twice per day and would shop at midday to avoid further depreciation of their earnings. Hyperinflation is a wasteful game of "hot potato" where individuals use up valuable resources trying to avoid holding on to paper money.

The recent examples of very high inflation have mostly occurred in Latin America. Argentina, Bolivia, Brazil, Chile, Peru, and Uruguay together experienced an average annual inflation rate of 121 percent between 1970 and 1987. One true hyperinflation occurred during this period. In Bolivia prices increased by 12,000 percent in 1985. In Peru in 1988, a near hyperinflation occurred as prices rose by about 2,000 percent for the year, or by 30 percent per month.

The Latin American countries with high inflation also experienced a phenomenon called "dollarization." Dollarization is the use of U.S. dollars by Latin Americans in place of their domestic currency. As inflation rises, people come to believe that their own currency is not a good way to store value and they attempt to exchange their domestic money for dollars. In 1973, 90 percent of time deposits in Bolivia were denominated in Bolivian pesos. By 1985, the year of the Bolivian hyperinflation, more than 60 percent of time deposit balances were denominated in dollars.

What caused high inflation in Latin America? Many Latin American countries borrowed heavily during the seventies and agreed to repay their debts in dollars. As interest rates rose, all of these countries found it increasingly difficult to meet their debt-service obligations. The high-inflation countries were those that responded to these higher costs by printing money. The Bolivian hyperinflation is a case in point. Eliana Cardoso explains that in 1982 Hernan Siles-Suazo took power as head of a leftist coalition that wanted to satisfy demands for more government spending on domestic programs but faced growing debt-service obligations and falling prices for its tin exports. The Bolivian government responded to this situation by printing money. Faced with a shortage of funds, it chose to raise revenue through the inflation tax instead of raising income taxes or reducing other government spending.

About the Author

Michael K. Salemi is an economics professor at the University of North Carolina in Chapel Hill. http://www.econlib.org/library/Enc/Hyperinflation.html

as an indexer for all prices in the economy. Dollarisation of the economy thus was prevented because agents did not need to flee to the dollar to protect their assets given the legal mechanism of indexation. The strategy was to create a proto-currency that would work only as a unit of account. The exchange rate of this proto-currency (called URV, or Real Unit of Value) in relation to the legal currency would be calculated as a function of a basket of general-use price indexes, in accordance with a previously announced formula.

The conversion of prices was voluntary and the government concerned itself only with establishing clear rules for the conversion of some services (school tuitions and rents, for example), the prices of public tariffs and wages, which were to be converted from legal currency to URVs based on the real average of the four months prior to the implementation of the plan. In other words, the need for the plan to be neutral from the distributive point of view was maintained. All of these points were exhaustively presented to the public in a way that there were no surprises to the stakeholders.

Over the first three months that the URV was in effect the public became increasingly used to the new unit of account, even though to settle their purchases they used a currency that lost value on a daily basis. After three months, economic agents were required to display the price of their products in both the legal currency and URVs. The economy was then full indexed, on July 1, 1994, the old currency ceased to exist and the central bank began to issue a new currency, called the real, which was worth exactly one URV. In that instant inflation fell from 30% per month to less than 20% per year.

What have we learned from Brazil's anti-inflation plan period? First, society must be keenly aware of the consequences of high inflation. Government, business, and the average person must all agree that inflation is an ill that must be tackled and they all must be prepared for any bumps along that road in order to succeed. Secondly, do not attempt to carry out social justice programs during an anti-inflation plan. Efforts to increase wages, for instance, will only jeopardize the success of the plan. Thirdly, taming inflation is not the solution of all problems.

It's just one important step along the development path.

This is an abridged version of Dr. Megale's keynote presentation at the "Just Business" forum hosted by the American Business Association of Zimbabwe (ABAZ) in Harare last year. The full paper can be obtained from ABAZ, e-mail abaz@mweb.co.zw.

Dr. Caio Megale, is Partner and Chief Economist at Maua Investimentos, Brazil. Dr. Megale was the 2005 recipient of the Brazilian Development Bank (BNDES) Economy Award.

Tackling governance concerns first step to restoring Zimbabwe's prosperity, says U.S. Ambassador

News and Views Staff Writer

The United States has welcomed the recognition by Zimbabwe's central bank that the primary cause of the economic decline in Zimbabwe is governance and says such an acknowledgment could mark an important step in restoring prosperity to Zimbabwe.

In a response to the Reserve Bank (RBZ) Governor's monetary policy statement, Christopher Dell, U.S. Ambassador to Zimbabwe, praised Gideon Gono, RBZ Governor, for speaking out and said the U.S. will be supportive "if the Zimbabwean government is sincere in its desire to improve governance by embracing economic and political reforms."

"I welcome his courage in speaking out and his recognition that the primary problem in Zimbabwe today is governance. The Governor also deserves commendation for recognizing that Zimbabwe's problems are of Zimbabwe's making and are within the power of Zimbabweans to solve," said Ambassador Dell.

Zimbabwe's economy has shrunk by more than a third in the past seven years as the country suffers a deep recession exacerbated by widespread human rights abuses, disregard of property rights and increasing corruption. The World Bank's 2007 Global Economic Prospects report released last December says it expects the economy to shrink by 3.3 percent in 2006.

Government officials blame the recession on "sanctions". However, the financial and travel sanctions were imposed on around 100 individuals most responsible for undermining Zimbabwe's prosperity and democracy.

Ambassador Dell said "sanctions have been a convenient excuse but neither the U.S. nor any other country has imposed general sanctions on Zimbabwe."

The U.S. ambassador also dismissed outright allegations peddled in the state media that his government has directed U.S. companies in Zimbabwe to either close or relocate.

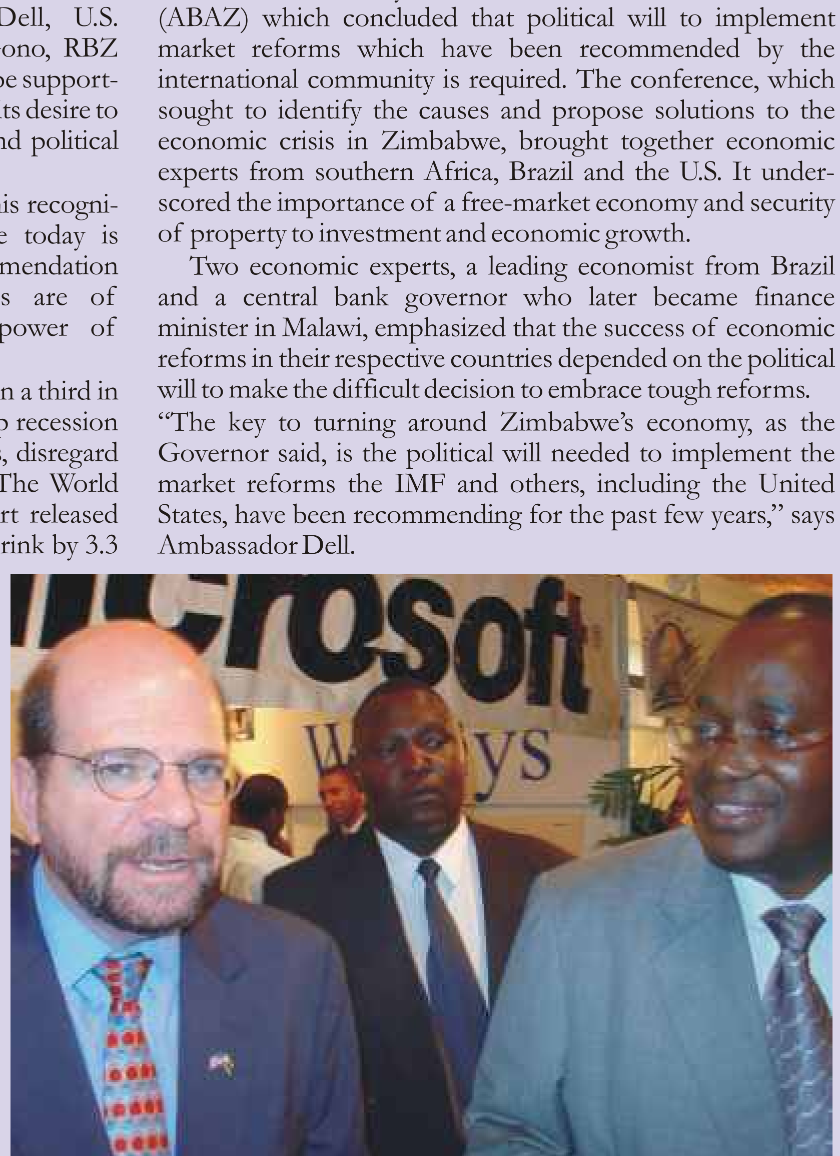
"In fact, contrary to recent press reports, U.S. companies, with the support of the U.S. government, continue to do business in Zimbabwe, and Zimbabwe enjoys a trade surplus with the U.S."

There are about 25 American companies operating in Zimbabwe, in addition to numerous Zimbabwean distributors of U.S. products. Some American companies in the agro-processing, manufacturing and services sectors have sharply downsized their operations in Zimbabwe in the past five years because of the economic collapse of the country and the loss of investor confidence in the Zimbabwean Government.

Governor Gono's call echoes the recommendations of a recent conference by the American Business Association (ABAZ) which concluded that political will to implement market reforms which have been recommended by the international community is required. The conference, which sought to identify the causes and propose solutions to the economic crisis in Zimbabwe, brought together economic experts from southern Africa, Brazil and the U.S. It underscored the importance of a free-market economy and security of property to investment and economic growth.

Two economic experts, a leading economist from Brazil and a central bank governor who later became finance minister in Malawi, emphasized that the success of economic reforms in their respective countries depended on the political will to make the difficult decision to embrace tough reforms.

"The key to turning around Zimbabwe's economy, as the Governor said, is the political will needed to implement the market reforms the IMF and others, including the United States, have been recommending for the past few years," says Ambassador Dell.



US Ambassador met Reserve Bank of Zimbabwe Governor Mr Gideon Gono at the IT Expo in 2005

Back to Basics 10 Myths About Governance and Corruption

by Daniel Kaufmann

Governance—which remains a sensitive and misunderstood topic—is now being given a higher priority in development circles. A few donors and international financial institutions (IFIs) have begun to work with some emerging economies to help reduce corruption, and encourage citizen voice, gender equality, and accountability. When the Group of Eight countries announced in July their decision to double aid and debt relief to the poorest countries in Africa, governance concerns were prominent. And in May, the joint report by the Africa Commission explicitly stated: "Good governance is the key... Unless there are improvements in capacity, accountability, and reducing corruption... other reforms will have only limited impact."

But are good governance and controlling corruption really so fundamental for development? The explosion of empirical research over the past decade, coupled with lessons from countries' own experience, have given us a more solid basis for judging the effect of governance on development, and the effectiveness—or lack thereof—of strategies to improve it. Yet there are still unresolved questions and debates in the development community, not only about the importance of governance, but also about the ability of IFIs to help countries improve on it. Let us therefore go back to basics and address some prevailing "myths" about governance and corruption.

Myth #1:

Governance and anti-corruption are one and the same. We define governance as the traditions and institutions by which authority in a country is exercised for the common good. This includes the process by which those in authority are selected, monitored, and replaced (the political dimension); the government's capacity to effectively manage its resources and implement sound policies (the economic dimension); and the respect of citizens and the state for the country's institutions (the institutional respect dimension). By contrast, corruption is defined more narrowly as the "abuse of public office for private gain."

Myth #2:

Governance and corruption cannot be measured. It is true that less than a dozen years ago virtually no internationally comparable measures of governance or corruption existed. But in recent years, the World Bank and others have sought to remedy this. At the World Bank, we have constructed aggregate governance indicators that cover more than 200 countries, based on more than 350 variables obtained from dozens of institutions worldwide. Our indicators cover the following six dimensions of governance: voice and accountability; political stability and the absence of major violence and terror; government effectiveness; regulatory quality; rule of law; and control of corruption.

While the indicators represent a big step forward, there are measurement challenges. Margins of error are not trivial, and caution in interpreting the results is warranted—one should not precisely rank countries. But these margins of error have declined, and are now substantially lower than for any individual measure of corruption, governance, or the investment climate. As a result, the World Bank's governance indicators are used worldwide for monitoring performance, for country assessments, and for research.

Myth #3:

The importance of governance and anti-corruption is overrated. Thanks to these and other advances in empirical measurement, a number of researchers have examined the impact of governance on development. The research generally shows that countries can derive a very large "development dividend" from better governance. We estimate that a country that improves its governance from a relatively low level to an average level could almost triple the income per capita of its population in the long term, and similarly reduce infant mortality and illiteracy. Such a relative improvement (by one standard deviation) would correspond, for instance, to a move up in our ranking for the "control of corruption" dimension in our database, taking Equatorial Guinea to the level of Uganda, Uganda to Lithuania, Lithuania to Portugal, and Portugal to Finland.

Governance also matters for a country's competitiveness and for income distribution. In the case of corruption, research suggests it is equivalent to a major tax on foreign investors. In many developing countries, corruption represents a "regressive tax" on the household sector as well: lower income families pay a disproportionate share of their incomes in bribes to have access to public services (compared with higher income groups), and often end up with less access to such services because of corruption. A rough estimate of the extent of annual worldwide transactions that are tainted by corruption puts it close to $1 trillion.

To make matters worse, aid-funded projects tend to fail in corrupt settings. And corruption undermines fledgling democracies. Of course, governance is not the only thing that matters for development. Macroeconomic, trade, and sectoral policies are also important. But when governance is poor, policymaking in other areas is also compromised.

Myth #4:

Governance is a luxury that only rich countries can afford. Some claim that the link between governance and incomes does not mean that better governance boosts incomes, but the reverse—higher incomes automatically translate into better governance. However, our research does not support this claim. It is thus misleading to suggest that corruption is due to low incomes, and invent a rationale for discounting bad governance in poor countries. In fact, the evidence points to the causality being in the direction of better governance leading to higher economic growth. A number of emerging economies, including the Baltics, Botswana, Chile, and Slovenia, have shown that it is possible to reach high standards of governance without yet having joined the ranks of wealthy nations.

Myth #5:

It takes generations for governance to improve. While it is true that institutions often change only gradually, in some countries there has been a sharp improvement in the short term. This defies the view that while governance may deteriorate quickly, improvements are always slow and incremental. For instance, there has been a significant improvement since 1996 in the "voice and accountability" indicator in countries ranging from Bosnia, Croatia, and Ghana, to Indonesia, Serbia, and Sierra Leone. And the improvements exhibited by some African countries in a short period of time challenge the "Afro-pessimists." Even so, it is sobering that, on average, there has not been a worldwide improvement in overall governance during this period—and in a number of countries, including the Ivory Coast, Nepal, and Zimbabwe, there has been a sharp deterioration.

Myth #6:

Donors can "ring-fence" projects in highly corrupt countries and sectors. With the possible exception of some humanitarian aid projects, the notion that the aid community can insulate projects from an overall corrupt environment in a country is not borne out by the evidence. The data suggest that when a systemic approach to governance, civil liberties, rule of law, and control of corruption is absent, the likelihood of an aid-funded project being successful is greatly reduced.

Myth #7:

Fight corruption by fighting corruption. A fallacy promoted by some in the field of anticorruption, and at times also by the international community, is that one "fights corruption by fighting corruption" through yet another anticorruption campaign, the creation of more "commissions" and ethics agencies, and the incessant drafting of new laws, decrees, and codes of conduct. Overall, such initiatives appear to have little impact, and are often politically expedient ways of reacting to pressures to do something about corruption, substituting for the need for fundamental and systemic governance reforms.

Myth # 8:

The culprit is the public sector in developing countries. A common fallacy is to focus solely on the failings of the public sector. The reality is much more complex, since powerful private interests often exert undue influence in shaping public policy, institutions, and state legislation. In extreme cases, "oligarchs" capture state institutions. And many multinational corporations still bribe abroad, undermining public governance in emerging economies. There are also weaknesses in the nongovernmental sector. Further, traditional public sector management interventions have not worked because they have focused on technocratic "fixes," often done through technical assistance importing hardware, organizational templates, and experts from rich countries.

Myth #9:

There is little countries can do to improve governance. Given the long list of interventions that have not worked, as well as the role often ascribed to historical and cultural factors in explaining governance, it is easy to fall into the pessimist camp. That would be a mistake. First, historical and cultural factors are far from deterministic—witness, for instance, the diverging paths in terms of governance of neighboring countries in the Southern Cone of Latin America, the Korean peninsula, the transition economies of Eastern Europe, and in Southern Africa. Second, there are strategies that offer particular promise. The coupling of progress on improving voice and participation—including through freedom of expression and women's rights—with transparency reforms can be particularly effective.

Toward a transparency reform scorecard

The data suggest that transparency helps improve governance and reduce corruption—essential ingredients for better development and faster economic growth. But there is a need for the development aid community to pay more attention to the issue. For that reason, at the World Bank Institute we have begun to construct an index to help make transparency more transparent. Further, in terms of reforms, a basic checklist, which countries may use for self-assessment, includes: public disclosure of assets and incomes of candidates running for public office, public officials, politicians, legislators, judges, and their dependents; public disclosure of political campaign contributions by individuals and firms, and of campaign expenditures; public disclosure of all parliamentary votes, draft legislation, and parliamentary debates; effective implementation of conflict of interest laws, separating business, politics, legislation, and public service, and adoption of a law governing lobbying; publicly blacklisting firms that have been shown to bribe in public procurement (as done by the World Bank); and "publish-what-you-pay" by multinationals working in extractive industries; effective implementation of freedom of information laws, with easy access for all to government information; freedom of the media (including the Internet); fiscal and public financial transparency of central and local budgets, adoption of the IMF's Reports on Standards and Codes framework for fiscal transparency, detailed government reporting of payments from multinationals in extractive industries, and open meetings involving the country's citizens; disclosure of actual ownership structure and financial status of domestic banks; transparent (web-based) competitive procurement; country governance and anti-corruption diagnostics and public expenditure tracking surveys (such as those supported by the World Bank); and transparency programs at the city (and sub-national) levels, including budgetary disclosure and open meetings.

Myth #10:

There is not much the IFIs can do.

Some development experts are skeptical about the ability of IFIs and donors to help countries improve their governance—either because of a conviction that "the 'macro' matters more," a mistaken belief in historical "determinism," or a view that the interventions needed to improve governance are politically sensitive and thus difficult for outsiders to encourage. Surely, there are areas that fall outside the mandate of IFIs, such as promotion of fair multiparty elections. But initiatives to encourage transparency, freedom of information and an independent media, participatory anti-corruption programs led by the country, and gender equality—all of which have been under-emphasized so far in the fight against corruption—may well be within the ability of IFIs and donors to do something about. Such initiatives, complemented by supporting targeted reform of highly vulnerable institutions (which often include procurement, tax, customs, or the judiciary) offer much promise.

The challenge of governance and anti-corruption confronting the world today strongly argues against the "business-as-usual" modus operandi. A bolder approach is needed, and collective responsibility at the global level is called for. The rich world must not only deliver on its aid and trade liberalization promises, it must also lead by example. OECD countries should ratify and effectively implement the 2003 UN convention against corruption, and take steps (as Switzerland is starting to do) to repatriate assets looted and stashed abroad by corrupt officials. And transnational corporations should refrain from bribery and support improving governance practices in host countries. As for the IFIs and donors, there is a need to grapple with questions of selectivity and effectiveness in aid programs, anchoring aid decisions within a governance prism and helping countries build capacity to effectively absorb aid. Improving transparency will be key. Finally, countries themselves must take the lead in improving governance.

Daniel Kaufman is the Director of Global Programs at the World Bank Institute.

For more information visit, http://www.worldbank.org

A Funding Partnership

USAID Development Credit Authority

The Development Credit Authority (DCA) enables USAID to offer partial loan guarantees that advance development objectives throughout the world. Under funding authority enacted by Congress, USAID enters into risk sharing arrangements with local financial institutions, generally guaranteeing no more than 50% of a loan or portfolio of loans. This approach ensures that local financial institutions maintain substantial risk and have ample incentive to undertake thorough due diligence and project oversight. DCA partial loan guarantees are combined with grant-financed training and technical assistance to support development activities in underserved private markets. The use of DCA guarantees by USAID missions has grown substantially in recent years, with a current total of over 144 projects across 39 countries. DCA guarantees often establish the foundation for relationships that continue the flow of credit to underserved sectors long after DCA's involvement has ended.

In FY 2005, DCA guarantees were targeted to critical areas in the developing world. They mobilized lending to micro and small enterprises damaged by the tsunami in Indonesia and supported small and medium-size enterprise lending in the West Bank and Gaza. In Serbia, DCA was used to channel $10 million in loan capital to municipal lending. DCA also promoted agribusiness lending in Ethiopia, Kenya, Moldova, Rwanda, Tanzania and Uganda.

In FY 2006, USAID will fund administrative costs for the development, implementation and financial management of all USAID credit activities ($7,920,000) and will use transfer authority ($21,000,000) for the subsidy cost associated with using DCA to guarantee loans and loan portfolios. This will support innovative financing of water and sanitation facilities in developing countries under the Presidential Water Initiative. DCA will also promote the flow of credit to micro finance institutions, small and medium enterprises, agribusinesses, energy-efficiency projects and municipalities in USAID-assisted countries.

In FY 2007, USAID plans to fund administrative costs for the development, implementation and financial management ($8,400,000) of all USAID credit activities and will use transfer authority ($21,000,000) for the subsidy cost of using DCA to guarantee loans and loan portfolios. This transfer authority will allow for guarantees of loans and loan portfolios in every region of the globe and every economic sector targeted by USAID. In addition, the Agency plans to use $5 million for the Africa Housing and Infrastructure Facility (AHIF). This innovative credit facility will build on USAID's experience with DCA and will support subsidy costs of partial guarantees for private sector financing of water, infrastructure, and housing projects in Africa, focused primarily on small and middle market housing and infrastructure projects. The AHIF will enhance the effectiveness of USAID's response to Presidential Initiatives such as Water for the Poor. The $3 million in subsidy would leverage up to $55 million in infrastructure financing in 2007. Up to $2 million may be used for project development costs, including one-time start up expenses associated with developing early stage AHIF projects, such as conducting feasibility studies.

Development Credit Assistance	FY 2004 Actual	FY 2005 Actual	FY 2006 Appropriation	FY 2007 Estimate
Credit Subsidy				
DCA Transfer authority	[21,000]	[21,000]	[21,000]	[21,000]
Direct Appropriation *	-	-	-	5,000
Administrative Expenses				
Appropriation for DCA	7,953	7,936	7,920	8,400

** Up to $2 million may be used for project development costs*

www.usaid.gov

USAID Wins Awards for Effective Communications Abroad

Washington, D.C.

The United States Agency for International Development (USAID) was recently recognized by the League of American Communications Professionals (LACP) in its Top 50 Overall Communications Campaigns list for 2006. In addition, USAID was honored with Magellan Awards from LACP for its local community relations campaigns in both Ecuador and Bosnia and Herzegovina. The Magellan Awards, which received more than 400 entries from around the world, is a competition conducted to recognize excellence in communications campaign practices.

USAID/Ecuador's campaign, in coordination with the U.S. Embassy, Ecuador's development organization (UDENOR), and local non-governmental organizations, helps the people of Ecuador better understand the benefits that come from long-term commitments to improve water quality, sustainable economic growth and the construction of better infrastructure in the Northern Border region. For its communications work in Ecuador, USAID placed number 20 in the Top 50 category as well as winning the first-place Platinum Award in the Community Relations category.

USAID's efforts to raise awareness of U.S. assistance in Bosnia and Herzegovina were also well recognized by LACP. The communications campaign USAID/Bosnia-Herzegovina: 10 Years of Foreign Assistance earned the Silver Award in the Community Relations category for its "beautiful job reflecting the local culture through the materials' design," said a LACP judge. The campaign focused on the ongoing partnership between the U.S. and the local populations to provide loans that have generated more than 16,000 jobs, improve the banking systems and local governance practices, and repair the region's war torn infrastructures.

"These two awards are indicative of USAID's continuing commitment to effective and clear communication in our work," said Joseph Fredericks, USAID's Director of Public Information. "The Ecuador and Bosnia and Herzegovina efforts highlight different aspects of our work, but they share the common element of using media to spread the message of the U.S. commitment to better the lives of people around the world."

Nobel Prize Awarded for Contribution to Pro-Poor Business Development

As the Nobel Committee awarded the Nobel Peace Prize to Muhammad Yunus and the Grameen Bank, we are all reminded again of the important role microenterprises can play in economic development and poverty reduction. In the era of globalization, we face the dual development challenges of generating economic growth and reducing poverty.

The United States has long supported the extraordinary work of Dr. Yunus. In 1965, as a young economist, Dr. Yunus received a Fulbright Scholarship from the Department of State to study economics at Vanderbilt University. Microenterprise development has been an important component of U.S. foreign assistance for over thirty years. The United States has supported micro and small enterprises (MSES) through assistance programs which provide access to financial and business services; facilitate participation in markets; and enable the poor to participate in business development. Around the globe, the U.S. is the leading bilateral donor for microenterprise development, which includes micro finance. In 2005 the U.S. provided $221 million in microenterprise assistance. These funds have acted as a catalyst for additional funding by banks, other private sources, and multilateral institutions, thereby making more resources available for sound business initiatives by the world's poorest citizens.

The United States Agency for International Development (USAID), the primary civilian foreign assistance agency for the U.S. government, provides microenterprise funding for more than 3.8 million entrepreneurs and households throughout the world. USAID accomplishes this assistance in a variety of ways: by supporting NGOs, Credit Union Networks and Financial Institutions. Micro finance projects particularly assist women in developing countries, who have traditionally had limited access to conventional financing. They also allow MSES to take advantage of the benefits of globalization through increased export opportunities.

Dr Muhammad Yunus

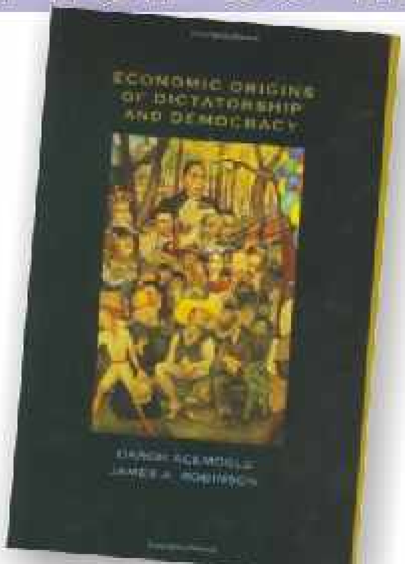
As MSES expand and integrate into the formal economies of their countries, they empower and transform the lives of the world's poor, both women and men, create more jobs and higher incomes, contribute to economic growth and strengthen democratic societies. In announcing the award, the Norwegian Nobel Committee stated "Every single individual on earth has both the potential and the right to a decent life. Across cultures and civilizations, Yunus and Grameen Bank have shown that even the poorest of the poor can work to bring about their own development."

The Nobel Prize is recognition of the key role micro finance plays in alleviating poverty and empowering citizens. As the Nobel Committee noted in its announcement, "lasting peace cannot be achieved unless large population groups find ways in which to break out of poverty. Microcredit is one such means. Bottom up development from the grassroots level also serves to advance democracy and Human Rights." Muhammad Yunus and Grameen Bank have helped create the enabling conditions for economic and social development from below. We salute them for their efforts to alleviate poverty and promote prosperity through innovative micro financing and we look forward to working cooperatively with Dr. Yunus and the micro finance community in the future.

What's in it for us then?

- A book review

by Tim Harford



ECONOMIC ORIGINS OF DICTATORSHIP AND DEMOCRACY:
Economic and Political Origins
by Daron Acemoglu and James A. Robinson
Cambridge University Press £25, 540 pages

The birth of British democracy was protracted, as the ruling classes slowly allowed the voting franchise to expand. In 1832 the first reform act increased the electorate from about 8 per cent of the population to 15 per cent; several further reform acts continued the process, and it was completed with near-universal suffrage in 1928. While the concessions were gradual, designed to stave off reform rather than hasten democracy, they all moved in the same direction.

Argentine democracy, by contrast, flickered on and off throughout the 20th century. Something resembling universal male suffrage was introduced in 1916 but was rendered irrelevant by coups in 1930, 1943, 1955, 1966 and 1976.

Non-democracies also differ from each other. Singapore's dictatorship has delivered such riches that popular opposition is half-hearted; whereas South Africa's apartheid regime was tempted into ever-greater acts of repression.

With these four cases, Daron Acemoglu of the Massachusetts Institute of Technology and James Robinson of Harvard begin an ambitious attempt to explain the different paths that democracies and non-democracies can take when viewed in retrospect: steady progress as in Britain; oscillation in Argentina; stable, high-performance dictatorship in Singapore or the repressive apartheid regime. What they produce is an abstract model that will infuriate historians but deserves their attention.

The authors are distinguished economists: Acemoglu recently won the John Bates Clark medal, a decoration rarer than the Nobel prize in economics (it's awarded every two years, and never to multiple recipients). Acemoglu's immediate predecessor was Steven Levitt, co-author of the best-selling book Freakonomics. Anyone expecting Acemoglu to produce something similarly crowd-pleasing will be disappointed. Acemoglu teamed up not with a professional writer but with a long-standing academic collaborator, and produced a book that will be impenetrable to the layman. Nevertheless, I expect Economic Origins of Dictatorship and Democracy to be highly influential.

Acemoglu and Robinson model the struggle for democracy as a piece of game theory - a strategic contest between a small number of players. Social classes are collapsed into individuals: the basic model is a two-player struggle between the "elite" player and the "citizens" player. The players are rational, foresighted, take each other's responses into account and are motivated by economic interest rather than ideology.

Game theory is an ostentatiously spartan tool for analysing mass historical movements. Intra-group conflicts and distinctions between different types of democracy are swept aside.

Acemoglu and Robinson know they are simplifying aggressively: they often use the phrase "Occam's Razor", meaning that by shaving away superficial historical details, they will expose the underlying structure of the emergence of democracy. I think it's worth suspending disbelief to see where the model goes - but historians and political scientists may be less patient with its reductionism.

Acemoglu and Robinson say the fundamental problem they expose is how rebellious citizens turn temporary opportunity into permanent advantage. The citizens have revolted, leaving the fields, taking the elites and their standing armies by surprise, and seizing the moment: how can they use their fleeting power to secure lasting concessions for the future? Faced with an imminent revolution, the elites will offer to change their ways. But since a revolutionary movement can't be sustained forever, how can the citizens be sure the elites will deliver once they have picked up their ploughshares once again?

Viewed from the other side, how can the elites offer credible concessions to a temporary insurrection? The initial temptation is not to bother. For example, in 1905, mutiny on the Battleship Potemkin helped simmering discontent in Russia to boil over. Tsar Nicholas II published the October Manifesto, granting freedom of speech and association, guaranteeing no imprisonment without trial, and establishing an elected legislative body, the Duma. The revolutionary threat cooled, and Nicholas II promptly changed his mind, disbanding the Duma in less than three months.

Twelve years later, the revolutionaries were less interested in compromise.

Acemoglu and Robinson's formulation reminded me of an old game theorist's story, the kidnapper's dilemma. The hostage is taken; the kidnappers have temporary power. But how to swap the hostage for the ransom, or for safe passage? A Woody Allen routine once captured the inherent difficulty of the negotiations: "The FBI surround the house. 'Throw the kid out,' they say, 'give us your guns, and come out with your hands up.' The kidnappers say, 'We'll throw the kid out, but let us keep our guns, and get to our car.' The FBI say, 'Throw the kid out, we'll let you get to your car, but give us your guns.' The kidnappers say, 'We'll throw the kid out, but let us keep our guns - we don't have to get to our car.'

The FBI say, 'Keep the kid'."

Acemoglu and Robinson argue that for the elites as well as the FBI, the answer to this dilemma is to give up the kid. That is, the elites can irrevocably hand over some power to the masses by creating democratic institutions. By doing so they dissipate the threat of revolution and keep some power for themselves, too. The concession is more credible than offering a change in policy (such as bigger welfare payments or lower taxes) because policies are easily changed but democratic institutions are not easily disbanded. Because the concession is more credible, it is also more effective: by making such concessions the elites avoid revolution.

That, then, is the story of how democracy emerges: it's a way of committing to reforms when the likely alternative is the guillotine or the firing squad. But what about those cases when democracy does not emerge, or does not last? Or the revolutionary forces ignore concessions from the elites and seize power in a civil war, perhaps destroying much of what they sought to control in the process. Or some general decides that a coup is in order after democracy appears to have developed. Or the elites decide that they would rather repress rebellions with ever-greater violence than concede anything.

Acemoglu and Robinson argue that these scenarios tend to hinge on predictable factors. For example, the elites will concede democracy more readily if they have less reason to fear severely redistributive taxes. Land is especially easy to tax, so landed gentry will oppose democracy more violently than industrialists would. Other important determinants include the level of inequality, the ease with which civil society organises itself, and the frequency of economic crises. In practice, this is a model that may prove helpful in explaining long-term patterns of emerging democracies; it will not serve as a handbook for today's nation builders.

The thesis is compellingly inventive. It has to be: Acemoglu and Robinson do not back it up with empirical work. Their case studies are sparsely distributed in the book, and designed only to illustrate its argument. This is a surprise, because both writers, with Simon Johnson of MIT, have done breathtakingly inventive empirical studies of economics and political institutions.

The use of game theory is not wholly satisfying, either. Social or economic classes do not act in unison. Acemoglu and Robinson recognise this - indeed, the fact that citizens cannot organise a rebellion on a whim is the pivotal point of the argument. But the flexible assumption that a social class can sometimes be treated as a single decision maker, and sometimes cannot, is a worrying weak link in the chain of reasoning.

Despite these imperfections and their highly technical models, Acemoglu and Robinson will deservedly win an audience. Students of economics will study this text as much for its methodical exposition and academic proofs as for its conclusions. They will find the effort well worthwhile.

POSTAGE

Publisher
Ambassador Christopher Dell
United States Embassy

P. O. Box 4010
Harare
Zimbabwe
Tel: 263-4-758800/01

Executive Editor
Paul Engelstad
Public Affairs Officer

Assistant Editor
Mark Weinberg
Assistant PAO